United States Circuit Court of Appeals

Nos. 8850 and 8851

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee,

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

REPLY BRIEF OF APPELLANTS

JEROME GOLDMAN,
THOMAS C. LAVERY,
Attorneys for Appellants.

A. JULIUS FREIBERG,
Of Counsel.

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REPLY BRIEF OF APPELLANTS

REPLY TO APPELLEE'S POINT I

Appellee asserts (Br. 10) that under Section 115 (a) and (b) of the Revenue Act of 1934, a corporation may not make any distribution except from earnings, so long as the corporation has any undistributed earnings since February 28, 1913, on hand. This is simply not so, as it completely ignores the exceptions stated in paragraphs (c), (d) and (i) of the same section, which authorize, free from taxation, bona fide distributions in cancellation or redemption of stock or otherwise properly chargeable to capital account. The distributions in the case at bar come squarely within those exceptions, being made in complete cancellation and redemption of stock.

Appellee's Cases Under His Point I

The cases cited by appellee (Br. 10-11) are clearly not in point, as not a single one of them involve the cancellation or redemption of any stock. We agree that distributions made to stockholders, *if not included in the exceptions provided in paragraphs (c), (d), and (i) of Section 115,* are presumed to be dividends from earnings to the extent that earnings exist whether they are called dividends by the corporation or not. We also agree that the books of the corporation or mere forms, do not control the situation, but that the facts determine the taxability of a transaction. However, the presumptions in paragraphs (a) and (b) in Section 115, by the express language of the Act, are not applicable where a distribution is in complete cancellation or redemption of all or part of an issue of stock.

Thus, in *Douglas* v. *Edwards,* 298 Fed. 229 (C. C. A. 2d), an attempted distribution charged to depletion reserve before earnings, was not permitted. No cancellation of stock was present.

In *Leland* v. *Commissioner,* 50 F. (2d) 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656, the corporation claimed that a distribution made had been from surplus and not from earnings, although earnings were on hand. The court held that the distribution would be deemed to come from earnings. In that case there was no reduction in capital or cancellation of shares of stock at all. Furthermore, the action was taken after the earnings were made, and was obviously an attempt to evade payment of dividends from earnings. None of these factors was present in the case at bar, where there was a change in the capital structure and cancellation of stock years before there were any such accumulations of earnings, and without regard to any tax law.

In *Hadley* v. *Commissioner,* 36 F. (2d) 543 (App. D. C.), a stockholder was taxed even though the credits he received from earnings of a corporation were not formally declared as dividends or so listed on the books of the corporation. Likewise, in *Christopher* v. *Burnet,* 55 F. (2d) 527 (App. D. C.), withdrawals by the holder of all of the stock of a corporation which were charged to him on the books of the corporation as purported loans, were deemed dividends from earnings. In neither of these two cases was any stock retired, and in both there was an apparent effort to evade the tax through subterfuge.

In *Lincoln Nat. Bank* v. *Burnet,* 63 F. (2d) 131 (App. D. C.), a distribution admittedly from earnings was considered to be dividends by the court, although not termed such by the corporation. Here, again, there was no stock redeemed.

In *Faris* v. *Helvering,* 71 F. (2d) 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584, affirming 26 B. T. A. 496, and *Walker* v. *Commissioner,* 26 B. T. A. 494, both of which cases involved recipients of portions of the same distribution, an attempt was made to distribute from capital in form, without, however, retiring any stock, while earnings were on hand. Here, again, the device was an apparent effort to evade the tax. The distributions were held taxable as dividends. In each of the cases the Board of Tax Appeals was careful to point out that no stock was retired or cancelled.

In *Anketell Lumber & Coal Co.* v. *United States,* 1 F. Supp. 724 (C. Cls.), the corporation had converted all of its assets to cash and was in process of liquidation. The owners of practically all of the stock withdrew large amounts from the corporation, calling their withdrawals loans on the books of the company. The court held that the withdrawals were in reality liquidating dividends. Again, in *Chattanooga Sav. Bank* v. *Brewer,* 17 F. (2d) 79 (C. C. A.

6th), certiorari denied, 274 U. S. 751, the sole owners of the stock in the corporation made withdrawals and charged them to their accounts on the books of the corporation as loans. The By-laws prohibited loans to stockholders. The court held that the withdrawals were in reality dividends. Both of these last two cases are examples of the principle that the Court will look through form, and that reality and not subterfuge is determinative of the taxability of a transaction.

However sound all of the above discussed cases may be, they clearly bear no analogy to the case at bar, where good faith is in no way challenged, because the transaction could not have been a device to evade any tax since it was in process long before any tax question was involved; and in the case at bar there was, as there was not in any of the above cases, a complete cancellation and redemption of part of an issue of stock.

REPLY TO APPELLEE'S POINT II

Appellee under this head argues that there was no real change effected by the reduction in capital and the cancellation of the 1220 shares of common stock, and that therefore the distribution in dispute was not a return of capital or a distribution in partial liquidation. Both appellee's premise and his conclusions are erroneous.

It is said that the corporation's books do not show the $122,000 as a debt due the stockholders and that interest was not paid thereon. The testimony was however that this fund should be available to the stockholders on their demand. There is certainly nothing in the company's books to contradict such an intention. The fact that a debt from the company to the stockholders was not set up on the books or that interest was not paid, makes no difference whatever, for, the company never denied the obligation. As the company could probably have used the money profitably until

the stockholders chose to withdraw it, and in fact did pay very substantial dividends every year without exception, it would have been impractical for the stockholders to charge interest, as that would merely mean taking the money out of one pocket and putting it into another.

The law is clear that the form in which an account is carried on the books is not determinative. The cases cited by appellee himself above analyzed show this, and, indeed, this is the claim of appellee. In addition to those cases, see also *English & Mersick Company* v. *Eaton,* 299 Fed. 646; *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 187 (1918); *United States* v. *Nipissing Co.,* 202 Fed. 803, 804 (1921); *United States* v. *Guggenheim Exploration Co.,* 238 Fed. 231, 236 (1917); *Southern Pacific Railroad Co.* v. *Muenter, et al.,* 260 Fed. 837, 838 (1919); *Baldwin Locomotive Works* v. *McCoach,* 221 Fed. 59 (1915); *Forty Fort Coal Co.* v. *Kirkendall,* 233 Fed. 704, 707 (1915).

In *English & Mersick Co.* v. *Eaton,* supra, the facts were the reverse of those in the case at bar. There the company's books credited certain earnings of the company to individual stockholders' accounts as dividends after an appropriate resolution declaring dividends. The company, however, claimed that these amounts should be considered invested capital for the purpose of calculating excess profits taxes, and not borrowed capital from the stockholders. The Commissioner of Internal Revenue claimed that the company was bound by its books, and that as the books showed the amounts credited to the individual stockholders, such amounts could not be considered invested capital. The court reversed the commissioner and held in favor of the taxpayer, saying on page 648:

> "Neither the Government nor the corporation is bound or concluded by the language of any resolution in the ascertainment of corporate intent."

In *Baldwin Locomotive Works* v. *McCoach*, supra, the court said:

> "The decisions under the . . . Income Tax Law are uniform to the effect that the government cannot base a claim for taxes on mere bookkeeping."

Thus, in the case at bar, merely because the books of the company do not show an account called "Debts Due Stockholders" does not mean that the stockholders were not entitled to withdraw their shares of the $122,000 fund at any time.

The more recent case of *Weaver* v. *Commissioner*, 58 Fed. (2d) 755, is very pertinent. There the stockholders contributed $100,000 to a corporation from funds credited to them on the books of the company, with the verbal understanding that at some future date the amounts thus contributed would be returned. This fund was carried on the books in an account called "Contributed Surplus." The corporation several years later returned this sum to the stockholders, although there were earnings of equal or greater amount on hand. The Board of Tax Appeals held that the distribution was taxable. The Circuit Court of Appeals reversed, stating that the understanding of the stockholders controlled, and that the payment was equivalent to repayment of loans from the stockholders. The facts in the case at bar are a great deal stronger, as here, not only by the express understanding of the stockholders, but as a matter of law, the corporation owed the money to the stockholders.

The records, however, in so far as they reveal any intention at all, bear out plaintiff's claim in that they show that the $122,000 was not to belong to the company. If the fund was to belong to the company, the records would indicate that the full value of the 1496 shares turned in, or $149,600,

was received by the company when it issued the 276 new shares, but the stock record (Appellant's Exhibit 10), on the contrary shows that the consideration received by the company for the 276 shares of new stock issued was only $100 per share, or $27,600 rather than $149,600, clearly establishing that the $122,000 excess representing the net of 1220 shares cancelled, was not intended to belong to the company.

Counsel for the appellee contends that twenty years had elapsed between the cancellation of the shares and the payment. This clearly can make no difference. As shown by the authorities cited in our original brief (pp. 16-20), the rights of the stockholders are established at the time the reduction of capital and cancellation of certificates occurs. In the case of *Jerome* v. *Cogswell,* 204 U. S. 1 (discussed pp. 16-17 of our main brief), several years had elapsed after the reduction in capital, and the remaining stock had passed into different hands, yet the court held that the stockholders who were such at the time of the reduction, were the ones entitled to receive the distribution when it was made some years later. In fact, in the case of *In Re Artisans' Land & Mtg. Corp.* (1904), L. R. 1 Chancery 796 (cited on page 19 of our original brief) the court held that even though as much as twenty years might elapse after the stock was cancelled, the stockholder was still entitled to maintain an action against the corporation for his money where the corporation denied the obligation. In the case at bar, the corporation has never disputed the obligation and has always been willing to pay whenever the stockholders might ask for their money.

In arguing that there was no real change in the stockholders' relation to the corporation before and after the reduction in capital and cancellation of stock, appellee simply pulls himself up by his own bootstraps. It is always true that where a corporation reduces its capital and calls

in a part of its common stock, redeeming a portion of each shareholder's holdings pro rata, the proportionate ownership of the common stock remains the same before and after the reduction and cancellation. Also, until distributed, the amount of capital represented by the cancelled shares is transferred from capital to surplus, but that surplus belongs to the holders of the shares which have been cancelled. (See authorities cited pages 16-20 of our main brief.) Appellee's argument would apply with equal force in every case where all or part of an issue of stock has been redeemed and cancelled. Yet where this is done, and there is no showing of artifice or evasion, the courts have uniformly held the distribution to be tax free. The case at bar can in no way be different, in so far as the relation of the stockholders of a corporation and their proportionate interests are concerned, from any of the cases where the courts have upheld such distributions.

The Trial Court Did Err in Rejecting Evidence and Such Error Was Not Harmless

Appellee argues that the trial court was correct in excluding the testimony of James A. Rheinstrom as to the background and purpose of the reduction of capital and cancellation of the 1220 shares, saying that it was hearsay and opinion evidence, and that the parties' understanding and intention were immaterial. The testimony offered was not hearsay or opinion evidence at all. Hearsay evidence is objectionable where it is sought to show through a witness a statement of fact made by another for the purpose of establishing the truth of the facts stated. But it is always proper to adduce evidence of what persons have said, to show their understanding, intent, or purpose. See *Jones on Evidence,* Section 350. If this were not so, an oral agreement could never be proved through a third party witness who heard it made.

However, the hearsay objection was eliminated entirely from this case, as Mr. Rheinstrom was questioned as to matters which lay within his own personal knowledge and recollection, and the trial court recognized this (R. 40-41). Who would be better qualified than Mr. Rheinstrom to state the intent and purpose underlying the corporate action, inasmuch as he was present at both the directors' and stockholders' meetings, he personally made the motion to reduce the capital, and as Secretary of the Company, wrote up the minutes?

The ground on which the trial court excluded the evidence was an erroneous application of the parol evidence rule (R. 30-31). As shown in our main brief (pp. 10-14), this was clearly error. Opposing counsel tacitly admit this, as they make no effort to differentiate or even comment upon the many authorities we have cited, and, indeed, say not one word to uphold the trial judge on this point. Instead, they say that if there was error, it was harmless error. Of course, we agree that error to be reversible, must be more than technical, but must prejudice substantial rights of the complaining party, and for that reason we are in accord with the rules laid down in the cases cited by appellee (Br. 18) in support of this principle. However, the error in excluding the proffered testimony was not harmless. It was seriously prejudicial to appellants.

Our opponents say the error was inconsequential on three grounds: (1) that the testimony was inherently improbable; (2) that it was immaterial; and (3) that the trial court considered it anyhow.

There is no basis whatever for the first ground. Mr. Rheinstrom is a man of the highest integrity and honor. No effort was made to impeach him, and he was not even cross-examined. Obviously the stockholders and directors must have had some reason for their actions, but the minutes of the corporation are silent as to that reason. An examination

of the tax laws of that time shows that no tax purpose was to be served. At no stage of the case, and not even now, have opposing counsel suggested what the purpose might have been if it had been in the slightest degree different from that solemnly sworn to by Mr. Rheinstrom. Opposing counsel have quoted (Br. 16-17) from the colloquy between counsel and the trial court when the excluded testimony was proffered, where the trial court made the comment "fantastic." This shows only that the trial court unfortunately had pre-judged the case, and had closed his mind to receiving any explanation for the otherwise unexplained corporate action. The understanding, as testified to by the witness, that the stockholders would have the right to draw down upon demand their respective portions of the surplus created by the reduction in capital and cancellation of the 1220 shares of common stock, was the only reasonable one that could have existed. If this had not been the understanding, then Mrs. Rheinstrom in agreeing to the corporate action, would, in effect, have been making a gift to Karl Kiefer of one-half of her interest in the assets of the corporation, and instead of being entitled to one-half of the $122,000 fund, would have been entitled to only one-fifth of it. (See our main brief pp. 21-24.) Opposing counsel concede this (Br. 21). The supposition that Mrs. Rheinstrom would have made such a gift to Karl Kiefer without any consideration, or any other reason, might be indeed characterized as "fantastic."

Appellee, as a second ground for contending that the error was harmless, says that the purpose and intent underlying the corporate action and the understanding of the parties, were immaterial. Inasmuch as the minutes were silent on this point, what could be more pertinent than this understanding, which is one of the chief issues in the case? While it is true that the understanding testified to is presumed in law even where not expressed (see our main brief

pp. 15-20), surely evidence of such an actual express understanding does not thereby become immaterial.

Finally, appellee says the error was harmless, because the court considered the rejected evidence anyhow. This cannot be so, because the judge still adhered to his ruling in his opinion. Furthermore, as pointed out above, the judge from the beginning determined not to permit such evidence to influence him. A judge cannot possibly give proper consideration to evidence when at the same time he considers it to be inadmissible and immaterial.

It is submitted that the error in excluding testimony was substantial and prejudicial, and not harmless.

A Real Change Took Place When the Capital Was Reduced and 1220 Shares of Common Stock Were Cancelled

Appellee, while conceding (Br. 19) that when stock is surrendered and cancelled a debtor-creditor relation arises between the corporation and the stockholders as to the stock that has been cancelled, insists that this general rule is not applicable in the case at bar, because, it is contended that the proportionate interests of the stockholders remained the same after, as well as before, the corporate action was taken. We have already shown (pp. 7-8 supra) the fallacy of this contention, and that in that respect this case is in no way different from any case where the capital is reduced and stock cancelled. The same argument as appellee makes here was urged in *Seeley* v. *N. Y. National Exchange Bank of N. Y.*, 8 Daly (N. Y.) 400, affirmed without opinion, 78 N. Y. 608 (1879), and was there rejected by the court. (See discussion pp. 18-19 of our main brief.)

Opposing counsel also apparently admit (Br. 19, 21) that the reduction in capital and cancellation of the 1220 shares of common stock did change the proportionate interests of the stockholders in the assets upon final liquidation (see

our main brief, pp. 21-23); yet insist somehow that the corporate action did not in reality affect the interests of the stockholders. On the very face of it, appellee's contention refutes itself. Appellee's argument treats a stockholder's proportionate interest in a corporation's assets as being wholly unimportant, a mere technical right of no real value, whereas the right to share in the assets upon liquidation is one of the most important rights a stockholder has. The value of his stock is determined as much by the proportionate interest in the corporation's assets which the stock represents as by anything else. Thus, although U. S. Steel did not pay common dividends for several years, its common stock still had a very substantial market value. When Mrs. Rheinstrom's interest in the assets of The Karl Kiefer Machine Company was cut in half by the corporate action in this case, she most certainly did suffer, not an insubstantial, but a very real change in position. The decision of the court below in effect, has, ex post facto, taken three-fifths of Mrs. Rheinstrom's interest in the $122,000 fund, and has given it to the legatees of Karl Kiefer.

There Was a Partial Liquidation Within the Terms of the Revenue Act

Appellee argues that even though part of an issue of stock was wholly redeemed and cancelled in this case there was no actual liquidation because the corporation continued in business as before. Appellee falls into the same error as the court below did in assuming that to have a "distribution in partial liquidation" under Section 115, it is necessary to have a partial cessation or curtailment of the corporation's business. This error arises through the failure to recognize that, as used in Section 115, "amounts distributed in partial liquidation" *are words of art*, and do not necessarily have their ordinary meaning outside of that section. Paragraph (i) of Section 115 expressly states:

> "As used in this section, the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

Paragraph (c) of Section 115 specifically excepts such "amounts distributed in partial liquidation" from the presumption in paragraph (b) of the same section that all distributions are to be deemed to be made from earnings to the extent that such earnings are on hand.

Under the definition in Section 115 (i), there need be no cessation or curtailment of business activities to have a distribution be one "in partial liquidation." So the courts have held.

In *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156 (1935) (C. C. A. 2nd), the court said at page 157:

> "A redemption of a part of the stock of a corporation, whether it be all of a class, such as of preferred stock, or a part of the common stock, has no necessary relation to the winding up of the corporation. . . .
>
> "Retirement of a portion of the stock of a corporation does not wind it up, and under sub-section (c), the distribution which is properly chargeable to capital account shall not be considered as a distribution of earnings or profits within the meaning of subsection (b)."

This language was followed with approval in *Kelly* v. *Commissioner*, 36 B. T. A. 507, at 515, and in *Britt* v. *Commissioner*, 40 B. T. A. 790, at 796-7.

In *Salt Lake Hardware Co.* v. *Commissioner*, 27 B. T. A. 482, a taxpayer who had previously received stock dividends which were redeemed, claimed (in order to avoid the normal tax on capital gains) that the distribution was a dividend from earnings, and not in partial liquidation, because the

company did not contemplate curtailing or winding up its business. The Board said at page 486:

> "That argument can have persuasive force only by using the word 'liquidation' in the sense of winding up the affairs of the company. Admittedly that is the usual meaning given to the word. But here we cannot ignore the fact that Congress has established a different meaning for income tax purposes. As set forth in the statute, section 201, supra (now section 115), a partial liquidation takes place whenever a corporation distributes money or assets in complete cancellation or redemption of a part of its capital stock."

The conclusions of the cases just cited not only are necessitated by the clear language of the statute, but are required as well by the discussion in the Committee Reports when Section 115 and its predecessors were pending in Congress. For the court's convenience we give excerpts from those reports in the Appendix, p. 17, infra.

Appellee's Cases

The cases cited by the appellee (Br. 21) are not at all analogous to the one at bar.

In *Gossett* v. *Commissioner*, 59 Fed. (2d) 365 (C. C. A. 4th), and in *Ward M. Canady, Inc.* v. *Commissioner*, 76 Fed. (2d) 278 (C. C. A. 3rd), the corporations were in the process of being wound up and distributions were made to stockholders. To avoid the normal tax on capital gains, the stockholders claimed the distributions were from earnings, but the courts held that since the corporations were actually in liquidation, the distributions would have to be considered as liquidating dividends.

In *Milton* v. *Commissioner*, 33 B. T. A. 4, the taxpayer had first claimed that a corporation had liquidated in 1929. Some years later after the statute of limitations had run

against his 1929 return, he found it to his advantage to claim that the corporation had liquidated in 1930. The Board held that actual liquidation was a matter of fact, and that the taxpayer's evidence was insufficient to overcome the commissioner's findings, and further that the taxpayer was estopped from changing his claim.

In *Menzies, Inc.* v. *Commissiomer,* 34 B. T. A. 163, the entire assets of a corporation were transferred to its largest stockholder in exchange for a note. The note was eventually paid in full. The corporation continued to pay its franchise and income taxes but invested its funds in real estate. The stockholder claimed the transaction was a sale and not a distribution in liquidation. The Board upheld the taxpayer, stating that from the facts there was a bona fide sale and not a liquidation.

In *Hellman* v. *Helvering,* 68 Fed. (2d) 763 (App. D. C.), the owner of all of a corporation's stock caused it to reduce its capital and call in 500 shares so that he could take a loss on those shares and thus reduce his income tax. The court held that the whole transaction was merely a bookkeeping arrangement, nothing more than a subterfuge, and the deduction was disallowed. Clearly, none of the foregoing cases are in any way relevamt to the case at bar, for here there is no claim or proof of bad faith, subterfuge or evasion. *The stock was cancelled long before any question of taxation arose.*

The only case cited by appellee which is analogous to the one at bar is *Kelly* v. *Commissioner,* 97 Fed. (2d) 915 (C. C. A. 2nd), *and that supports not appellee's but appellants' contentions.* There a corporation reduced its capital, cancelled one-half of its stock, but continued in business. The taxpayer received less for his stock upon redemption than he had paid for it. The court held that the distribution was in partial liquidation, and followed with approval the language from the *Quackenbos* case quoted supra, p. 13.

The court distinguished the *Hellman* case, supra, page 15, cited by appellee here, pointing out that in that case the transaction was not bona fide but a subterfuge.

Appellee argues that the determination of whether a distribution is one in partial liquidation is a question of fact, that that fact has been found against appellants by the trial court, and therefore must stand. We would agree to such a statement if such a conclusion were supported by any facts and the facts were in dispute. But here the facts are all undisputed, most of them stipulated and the rest uncontroverted. In such a case the Circuit Court of Appeals is not bound by the findings of the district judge, but is free to draw its own conclusions. *Parker* v. *United States*, 88 Fed. (2d) 907 (C. C. A. 7th). In the case at bar, outside of the question on which evidence was excluded by the trial court, the only issues are ones of law. The trial court's error on the question of partial liquidation was in failing to perceive that Section 115 (i) rendered the expression, "amounts distributed in partial liquidation," words of art, and in failing to follow their meaning as defined in that paragraph.

It is urged that the judgments below be reversed with instructions to enter judgments for appellants for the reasons stated.

Respectfully submitted,

JEROME GOLDMAN,
THOMAS C. LAVERY,
Attorneys for Appellants.

A. JULIUS FREIBERG,
Of Counsel.